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CARDINAL O'HARA MEMORIAL LECTURE BY
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BEFORE

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DEPARTMENT OF ACCOUNTANCY

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"PERSPECTIVES ON THE FEDERAL BUDGET"

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It is a great pleasure to be here with you today. Notre Dame has a much deserved reputation throughout the United States as a center of learning and spiritual inspiration. Coming to Notre Dame is like coming home for me. I was born in Elkhart, Indiana, some twenty miles from here, and visited the campus many times as a young boy. The first time I was here I saw the Notre Dame football team defeat Carnegie Tech in 1938. This game is rather well-known to a lot of old-timers. Notre Dame won the game 7-0 after there was a confusion over downs on one of Carnegie Tech's offensive series. Carnegie Tech, thinking it was third down, ran a play from scrimmage and failed to get a first down. The referee ruled that it had been fourth down. The ball went over to Notre Dame. They marched down the field and scored.

I would like to spend time today discussing two different, but related budget topics. First, I want to offer my perspectives on our current budget situation in the Federal Government and what I think ought to be done to correct it. Then I want to shift gears and describe the improvements I think are needed in the Government's financial management systems.

THE BUDGET SITUATION

In preparing my remarks, I was struck by the relevance of that 1938 football game to the budget situation facing the United States today. We need to pay much closer attention to where we are. Our budget deficits did not exactly creep up on us unnoticed. They have been developing for over 20 years. Recently, however, the actual and prospective budget deficits have become so large that many in the public press speak of an endless river of red ink. In fact, public concern is now so high that last January six former cabinet members, three of whom served

under Democratic presidents and three under Republican administrations, formed a bi-partisan coalition to draw the President's and Congressional attention to the fiscal crisis. The document they issued outlining the crisis and its implications drew over 500 supporting signatures from eminent Americans in commerce, finance, law, and education, including the President of this university. I am struck by the diversity of political and economic views represented by these 500 Americans, and I share their concerns.

Like them, I believe that the \$127 billion deficit in fiscal year 1982 and the expected deficit of over \$200 billion this fiscal year, though to some extent unavoidable because of the recession, are too large. And, what is more troublesome is that even with an economic recovery, in which full employment is reached in 1988, the deficit is projected to be \$300 billion.

This predicament does not bode well for continued economic growth, for a sustained recovery from our current recession, and for the health of some of our industries such as automobiles and steel.

In past decades, our country has benefited in a number of ways from economic growth. It has afforded us a rising standard of living which has enabled us to live longer and healthier lives and enjoy more of the material things in life. High rates of economic growth are made possible by high rates of investment in plant, equipment, research and development, and public infrastructure. These investments occur when the savings of the economy are available for private sector uses. Savings are not available for private investment when they are absorbed by the Government to finance its deficits.

This diversion of the savings from productive investment in new plant and equipment has been increasing at an alarming rate. During

the 1950s, the Federal budget absorbed less than one percent of personal savings. During the 1960s the total claim on personal savings was only 6 percent. During the 1970s, it climbed to 36 percent and for the first 3 years of the 1980s the absorption was a staggering 71 percent. The forecasts for the period 1983-88 show that only in the final year, 1988, will personal savings exceed the deficit. This absorption rate is a certain prescription for economic stagnation during this decade.

The prospect of large deficits during the 1980s poses a current obstacle to our emerging from the worst recession in 50 years. Because lenders and borrowers must anticipate large Federal claims on the nation's pool of savings for years to come, today's long- and medium-term interest rates, despite some recent decline, remain abnormally high relative to current inflation rates. Today's high real interest rates pose the principal threat to a sustained economic recovery.

Finally, our high real interest rates serve as a magnet attracting foreign funds to our shores. These flows, in turn, lead to an abnormally strong dollar on foreign exchange markets. A strong dollar works to the disadvantage of our export industries and those which compete with our imports.

Because our fiscal problem is at the national level, it is the Federal Government which must devise a solution. This does not mean that big Government is totally to blame for our problems. Those attacking the evils of large Government tend to forget that large Government has also been beneficial for the country.

Leadership at the Federal level was responsible for lifting us out of the Great Depression through creating programs like the Reconstruction Finance Corporation; for mobilizing the nation to achieve

victory in World War II; for formulating and carrying out the Marshall Plan for rebuilding Europe, called by Winston Churchill "the most unsordid act in human history"; for providing massive educational opportunities through the establishment of land grant colleges and a host of educational subsidies ranging from the GI bill to student loans; for providing us with a first rate highway system; for inspecting the meat we eat, the medicines we take, the water we drink, and the air we breathe; for stopping floods, bringing electricity to rural areas, and irrigating our deserts; and for striving to ensure equal rights for all.

WHERE DID WE GO WRONG?

If large Government had many past successes, how then did we work ourselves into the present fiscal crisis?

As I noted, our fiscal problems are not of recent origin but have been developing in varying degrees for the past 20 years. It occurs to me that over this period several events contributed to producing our current state of affairs.

The Great American Inflation

Almost 20 years ago, we decided to fight the war in Vietnam without putting the U.S. economy on a wartime footing. We attempted to fund the war, maintain the social programs embodied in the Great Society, and, at the same time, not reduce the standard of living of our citizens. This effort at war and social justice was financed in ways which set in motion the great American inflation--an inflation which, fueled by the oil crises of 1974 and 1978, has bedeviled our economy for a decade and a half and strengthened the effects on the budget deficit of the indexation of entitlement programs and our ability to raise tax revenues.

A Change In Budget Priorities

An examination of the changes in the Government's spending and taxing priorities sheds additional light on what has happened. Since the end of World War II, and especially since the 1960s, the growth of social insurance and entitlement programs has increased sharply. In 1960 we spent 28 percent of our budget on income security, social services, retirement benefits, and the like. By 1972, this spending had grown to 45 percent, and in 1982, to about 50 percent. This is almost a doubling in only two decades.

The increases in expenditures for these programs can be attributed to the way in which they are indexed to offset the effects of inflation, by changes in eligibility criteria, and by changes in the number of participants in each program. We, in GAO, found that between 1970 and 1977 indexing accounted for about half of the spending growth. Of somewhat less importance was the open-ended nature of these entitlement programs. While the Congress sets the standards of eligibility for the programs, it cannot directly control the rate of participation in them. As a result, total spending can vary dramatically without any congressional action, even in the absence of inflation and indexing. It is the rapid run-up in these costs which has given rise to the widespread concern that the budget may be out of control.

When the Congress first indexed these entitlement programs, there was a belief that maintaining real benefit levels for retirees and others was both noble and affordable, and should be removed from the political process. At the time, the U.S. economy was experiencing low rates of inflation. Our economic performance during the last 5 years has not been so good. The growth in our national productivity has declined markedly, inflation has frequently been in the double-

digit range and our economy has stagnated. In per capita terms, our real income has actually declined. Yet, this decline has not been shared to an equal extent between those who receive entitlements and those who do not.

In addition to entitlements, interest costs on the national debt have also soared. In 1970, net interest payments were a little less than 7 percent of total Federal expenditures. They increased to a little less than 9 percent by 1980 and, in 1982, they consumed over 11 percent of Federal expenditures. This growth in interest payments is the product of a number of factors, including the recent large deficits, debt financing policies of the Treasury, and inflation, which drove interest rates to 100-year highs.

One of the political themes of the 1960s was fiscal federalism, or revenue sharing. This translated into a program in which the Government redistributed tax revenues among the various States and localities. In 1960, these grants were almost 8 percent of Federal outlays. By 1970, they reached 12 percent of total Federal expenditures, and by 1980 they had risen to about 15 percent.

In view of the fact that social programs, interest, and aid to State and local governments grew as a share of the Federal budget, something had to give. After peaking at 64 percent during the Korean conflict, defense expenditures declined to 48 percent in 1960, 36 percent in 1970, and 23 percent in 1982.

The overall result of these changes has been enormous growth in Federal outlays due largely to the increasing role the budget has come to play in redistributing income among the population.

Finally, we have seen major changes in the sources of Federal revenues and an inability of total revenues to rise as a proportion of GNP due to a combination of tax rate cuts and erosion of the tax base.

In 1950, personal income taxes and corporate profit taxes provided 70 percent of total Federal revenues with each contributing about equal shares. Social insurance taxes, on the other hand, contributed about 12 percent of the total. Three decades later, nearly one-half of all Federal revenues were derived from the personal income tax, nearly one-third from social insurance taxes, and about 12 percent from taxes on corporate profits. The increase in the relative importance of social insurance taxes is due primarily to the fact that Social Security, the largest of these programs, is self-financing. Its revenues must grow by roughly the same amount as its expenditures have grown.

Despite these shifts in the relative importance of various revenue sources, for the past 12 years total Federal revenues have been a fairly constant proportion of GNP--ranging between 18-1/2 and 21 percent. In 1983, they are projected to be at the low end of this range. Because tax revenues have not kept pace with the growth in Federal outlays, we have had a long string of deficits.

The Picture That Emerges

What picture emerges from the chain of events that I have described?

Since the end of World War II, we have seen a change in our national priorities. For better or worse, we decided that primary responsibility for various social problems related to old age, health, and disability should be assumed at the Federal level. In dealing with these problems, we decided to establish real benefit levels by indexing. In doing so, we failed to anticipate the great American inflation, itself a legacy of the Vietnam War. This inflation led to a rapid run-up of expenditures to support the programs and for interest on a growing national debt to finance such programs. This, in turn,

made it difficult to raise revenues to finance other programs.

Recently, a series of decisions to reduce tax rates and index the tax system, as well as increased real outlays for rearmament coupled with a reluctance to reduce spending for entitlement programs, has only served to exacerbate the fiscal crisis.

WHERE DO WE GO FROM HERE?

Despite the merits of the views motivating the changes in policy that have taken place recently and over the last several decades, their effect on the Government's fiscal health poses a real threat to our economy. And, because of our interdependence with the economies of the rest of the world, the spectre of enormous deficits and a continuation of high real interest rates is even more alarming.

As Helmut Schmidt, former chancellor of West Germany, noted in a recent essay on the state of the world economy, "The world economy is in undeniably bad shape. But it is not incurable. Our problems are man-made, and they can be solved by man. But this means that governments must face up to their responsibilities. We cannot afford to believe in the invisible hand of the market so much that, as the American columnist Joseph Kraft puts it, we 'prefer not to acknowledge the visible hand of explicit policy'. The 'self-healing powers of the market' cannot take care of all our problems." Mr. Schmidt went on to say, "The United States will have to take the lead in the required reduction in world interest rate levels, if only because of its importance in the world. It accounts for about 40 percent of the national product of all OECD countries, around two-thirds of all official exchange reserves are held in U.S. dollars; and about three quarters of Euromarket loans are denominated in U.S. dollars and reflect American interest rates."

We must give the highest priority to putting our fiscal house in order. Our options for responsible action include raising revenues and reducing expenditures, and, within the expenditures area, to containing spending growth for both entitlement and defense programs.

Social programs and entitlements

I indicated that indexing social programs and entitlements and their open-ended nature were the main reasons for their soaring costs during the past decade and the widespread concern that the budget may be out of control.

Social Security, by far the largest of our social insurance programs, has been self-financed. Therefore, it could not directly contribute to deficits in more than a temporary way. Nevertheless, it has had an important indirect effect. If one accepts the premise that the Government tax claim on our national output should be limited if we are to achieve sustained economic growth, increases in taxes for Social Security may come at the expense of reductions in tax revenues from other sources, and this is what has happened. The ultimate result is that even in the case of Social Security, maintaining real benefits that are self-financed can indirectly contribute to deficits. For partially self-financed entitlement programs and those financed out of general tax revenues, the effect on the deficit of maintaining real benefit levels is more direct. I have to conclude that, regardless of whether these programs are self-financed or not, the real question is, can we continue to afford maintaining the level of benefits promised in better times than we are currently experiencing?

Our current economic circumstances, unforeseen by the Congress when it indexed these programs, warrant some modification in the indexing formulas, a more systematic review of eligibility criteria, and

relatedly, more stringent means tests to assure that the poor are adequately protected while at the same time modifying participation by certain program beneficiaries whose own source income levels are sufficient to maintain a decent living standard.

Defense

In his March 23rd address, President Reagan outlined the buildup of both strategic and tactical forces by the Soviet Union; a buildup that has continued unabated for two decades. Like the President, I believe that the Soviet Union possesses a formidable arsenal of weapons which constitutes a threat to the security of the United States. I also believe that a strong U.S. defense posture is the best deterrent to a super power confrontation. However, I believe that we can maintain a formidable and credible defense posture without engaging in the greatly accelerated defense buildup currently proposed.

This buildup must be slowed if we are to reduce the federal deficit. Also, the very large increase in our procurement demands may place severe strains on the Nation's defense industrial base. Federal officials must carefully consider current and future industrial capacity with an eye toward saving taxpayer dollars when planning buys, and setting procurement quantities and schedules. A realistic and stable acquisition program over a period of years will yield enormous benefits to our defense posture and help our budget situation.

At the same time, the Defense Department should recognize that the costs of maintaining and operating the complex equipment it is procuring, and proposing to procure, will place a strain on future defense budgets. We will soon find that adequately supporting what we have recently purchased and continuing the high level of investment in all new equipment will result in our doing neither well. We must recognize

that maintaining the weapons of the future may require eliminating some weapons purchases today. We simply cannot afford to put into production virtually all weapons developed under the Carter-Ford-Nixon administrations. We must not buy the weapons that have technological problems, or the weapons that have languished so long in the development stage that they simply grew obsolete with rapidly advancing technology. The savings from such actions would be primarily in future years. But, particularly in the defense procurement area, we must consider carefully the future costs of today's decisions.

In addition, the possibility of breakthroughs on the international and diplomatic fronts that could limit strategic and conventional forces should be fully explored.

Taxation

Finally, we need to reexamine the revenue side of the budget and stop the erosion of the tax base. There has been an increasing tendency for individuals and businesses to obtain subsidies through the Federal tax system by having a portion of their income exempted from taxation. Tax shelters, loopholes, and tax expenditures should be re-examined, as I believe Senator Dole and others are currently doing in the Congress. While these exemptions are justified on worthy social or economic grounds, there is increasing evidence that they fail in many cases to accomplish their stated objectives. In those cases, we merely forego a source of tax revenue to seek behavior that would occur without the subsidy. Such exemptions also have the potential to lead to serious misallocations of our scarce economic resources. They also add complexity to our tax code that leads to undermining what was once the best voluntary tax system in the world. It is essential that the public have confidence in the integrity, equity, and effectiveness of

our tax system. Otherwise, billions of dollars will continue to be lost because of taxpayer noncompliance.

The steps I have outlined to curb the growth in entitlement and defense programs and to raise tax revenues are reasonable and responsible in their own right. And, they will go a long way toward eliminating the massive deficits projected for the future, and eliminate the specter of continued high interest rates and stagnant economic growth both here and in the rest of the world.

FINANCIAL MANAGEMENT PROCESS IMPROVEMENTS

Let me now shift from the problems associated with the imbalance of the Federal budget to the financial management processes which support the formulation and execution of the budget.

One of the key functions of financial management is allocating the resources over which the Government has command. This process involves, to a large extent, assessing trade-offs among competing political goals. But, in order for the choices to be informed, it is essential that the information used by policymakers be as accurate and reliable as possible so that the costs of the choices are clear--especially the full long-term cost of major proposed programs. In order for such choices to be well-informed, we need much improved financial information.

Today's Federal decisionmakers are working with financial management systems that were designed for a bygone era. Many of these systems date back to World War II and the 1950s. These officials use planning, budgeting, and accounting systems that are not well integrated. The individual systems have become cumbersome as more and more requirements have been added to meet expanded needs for information. We must streamline and modernize these systems to meet the requirements

of those decisionmakers who must address the tough and complex issues associated with the budget dilemmas I have described.

During the past two decades, both the executive branch and the Congress have taken steps to strengthen their budgeting process. In the early 1960s, Mr. McNamara established a planning, programming, and budgeting system for the Defense Department. The defense budgeting system has been adapted to each administration's policy and management needs and, today, still represents the most comprehensive, integrated approach to supporting decisionmaking in the Federal Government. But this system is now 20 years old, and there are many areas in which it can be improved. In other Federal agencies, the systems are generally not as comprehensive and integrated.

In the 1970s, the Congress added a new budget process on top of the existing authorization and appropriations processes so it could better handle the overall Federal budget. To support and carry out the new budget functions, the Congress created new budget committees and the Congressional Budget Office. These new processes increased the demands on the systems at the same time that the issues being addressed were getting more complex and the budget itself became more important to policymakers. So the Congress also has found that its processes need to be streamlined and they are working on new approaches.

Accounting systems in the Federal Government have a different history. Prior to World War II, accounting was centralized in the General Accounting Office. During the build-up for World War II, the disbursement and accounting systems had to be decentralized quickly. After the war, at the recommendation of the Hoover Commission, legislation was passed that formalized the decentralization to the executive departments and agencies, with GAO providing guidance and retaining

responsibility for their review and audit. Generally, separate systems were created for payroll, administration, and program operation. Some attempts have been made to consolidate and integrate systems at high levels, but even these have not been integrated with budgeting. So today we find hundreds of accounting systems with narrow scopes and few linkages to other systems.

Auditing, evaluation, and oversight have also experienced major expansions because of policymakers' growing expectations about their capabilities. Decisionmakers want analysts doing review work to give them clear, specific recommendations for ways to save money, manage better, and get better results from the Government's activities. They also want to be told very generally how each agency is being managed. But reviews have tended to be narrow in scope, dealing with only a single aspect of an agency's activities. Therefore, it is often not possible to give overall assessments or make broad proposals on entire programs.

Thus, current financial systems of the central agencies and the many individual departments have grown up in an ad hoc fashion. Each was put in place to meet some perceived need at the time. But this evolution has yielded a patchwork set of arrangements characterized by gaps, hurdles, and failure of the parts to mesh well with each other. This has degraded the efficiency and effectiveness of the system as a whole, which can be made to function only through virtually superhuman efforts by the participants in the process.

We need to move to a broad concept of financial management in the Federal Government that encompasses the processes and functions associated with acquiring, managing, deploying, and accounting for the Federal Government's financial resources. We need systems that will

assure us that, to the maximum practical extent, these financial resources--and the real resources they represent--are acquired and used lawfully, efficiently, and effectively to achieve purposes of commensurate value to society. We need to ensure that policy officials and the public get clear, concise information on the Federal Government's stewardship of financial resources. I believe we can do a better job of reporting on as well as managing the resources, and I will be working with the Congress and the Executive Branch to develop a strategy and plan to create the needed systems.

CONCLUDING REMARKS

In 1975, then President Ford, when delivering his first State of the Union Address, said "the State of the Union is not good." He went on to say, "Million of Americans are out of work. Recession and inflation are eroding the money of millions more. Prices are too high and sales are too slow. This year's Federal deficit will be about \$30 billion; next year's probably \$45 billion. The national debt will rise to over \$500 billion."

We must, in 1983, once again realize and acknowledge that the financial health of the Government, as well as the economy, is not good. Though inflation appears to be under control, we have paid a heavy price; right now over 10 percent of our labor force is out of work. Our Federal budget appears out of control. Even in real terms, the \$300 billion deficits projected in a fully employed economy make the deficits that President Ford was worried about pale in significance.

I have briefly outlined the steps I believe should be taken to put our fiscal affairs in order. We must reduce the deficit through a combination of reductions in the growth in entitlement and defense programs and increase either tax rates, the tax base, or both. The burdens imposed

by these steps will involve sacrifices from all of us. In Government, we need a bi-partisan recognition of the problem and a resolve to deal with it. We also need the development of a consensus of agreement among public officials and the full spectrum of private interests on an equitable allocation of sacrifice. Without action we are faced with a continuation of unprecedented large deficits, high interest rates, a worsening trade balance, an enormous drain of savings from supporting private capital formation, a relatively stagnant U.S. and world economy and, at best, no improvement in our standard of living.

The consequences of not coming to grips with our budget problems are so serious that I am certain we will find the ways to resolve it. Our Government has faced problems of similar magnitude in the past and has dealt with them. I see signs of a developing bi-partisan recognition and resolve to deal with our problems. I believe that we, like Notre Dame in that 1938 football game, can make the most of this most fortunate turn of events.